"BACK-DOOR" RECAPTURE OF DEPRECIATION IN YEAR OF SALE HELD IMPROPER

Occidental Loan Co. v. United States
235 F. Supp. 519 (S.D. Cal. 1964)

Plaintiff taxpayer owned two subsidiaries, which were liquidated in 1958. Plaintiff acquired all the subsidiary's assets, including a parcel of land with residential rental units built thereon. The rental units cost 1,049,267.44 dollars, and were constructed and completed during the period between August and November 1957. Using the sum-of-the-years digits method over a twenty-five year term with no salvage value, plaintiff properly computed depreciation on the rental units. Plaintiff correctly deducted a total of 171,531.64 dollars from August 1957, to December 31, 1959. As of January 1, 1960, the adjusted basis of the land and improvements was 1,054,073.33 dollars. In September of that year plaintiff sold the property for 1,570,371.77 dollars, of which 877,735.80 dollars was attributable to depreciable improvements. Plaintiff took a deduction 49,191.44 dollars for depreciation on his federal income tax return, covering the period January 1 to September 12, 1960, the date of sale, applying the same method previously used. The Service took the view that, where property is sold for an amount exceeding the adjusted basis on the first day of the year, no depreciation shall be allowed for the year of sale. This policy was based on the apparent belief that it is per se wrong for taxpayers to make a profit, *i.e.*, receive capital gains treatment as a result of the depreciation deduction. The deduction was disallowed by the Commissioner, and plaintiff was assessed 27, 979.60 dollars in additional taxes and interest on the increased ordinary income. The plaintiff paid under protest and brought this action to recover the amount of the assessment. The district court allowed the refund in a well-reasoned opinion and in so doing, aligned itself with three other district courts,[1] and the Tax Court.[2] The Service's position parallels only the Second Circuit Court of Appeals.[3]

What the district courts and the Tax Court have based their opinions upon is not so much the merit of the taxpayer's case, but rather the utter lack of saving grace for the Service's position. Most would agree that it is not the purpose of the depreciation deduction to permit taxpayers the

[1] Wyoming Builders, Inc., v. United States, 227 F. Supp. 534 (D. Wyo. 1964); S & A Co. v. United States, 218 F. Supp. 677 (D. Minn. 1963); Kimball Gas Prods. Co. v. United States, 12 Am. Fed. Tax R.2d 5105 (W.D. Tex. 1962).

[2] The Tax Court as recently as 1962 considered the problem involved here. The case was Randolph D. Rouse, 39 T.C. 70 (1962), where the court decided against the taxpayer, citing Cohn v. United States, 259 F.2d 371 (6th Cir. 1958). Then in 1964, the Tax Court reversed itself in Macabe Co., 42 T.C. 87 (1964), and C. L. Nichols, 43 T.C. 14 (1964).

[3] Fribourg Nav. Co. v. Commissioner, 335 F.2d 15 (2d Cir. 1964); United States v. Motorlease Corp. 334 F.2d 617 (2d Cir. 1964).

favored capital gains treatment for what would otherwise be ordinary income. The majority of the courts have rejected the Government's argument to justify the disallowance [4] despite the presumption of correctness normally accorded the Commissioner's redeterminations. The courts have sensed that something was wrong with the Service's position, but until the Tax Court articulated the flaws in that position in *Macabe*,[5] the opinions were not entirely successful in explaining the dissatisfaction. Generally, the Government's flaw is in its reliance upon hindsight to show that the taxpayer has miscalculated depreciation for the year involved.

To state the obvious, it is clear that depreciable material assets wear out, but the extent of wear varies widely within the class. Beginning with cost minus a reasonable allowance for salvage, Congress has allowed a deduction for depreciation of certain business assets to be taken over each asset's estimated useful life.[6] Adjusted cost is denominated adjusted basis.[7] In a period of generally rising prices, cost is the most conservative figure reasonably allowable as a depreciable base.

For income tax purposes, the statute and implementing regulations [8] call for property to be depreciated by setting aside an amount each taxable year following a reasonably consistent plan. The aggregate amounts so set aside plus salvage value will, at the end of the estimated useful life, equal the basis of the property. But only by coincidence will the salvage value equal market value at the end of the assets' *actual* useful life. The reasonable useful life of property for tax depreciation purposes can only be developed and ascertained upon facts and information gained from past

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[4] *Supra* notes 1-3.

[5] Macabe Co., *supra* note 2.

[6] See generally Int. Rev. Code of 1954, § 167.

[7] Int. Rev. Code of 1954, § 1012.

[8] Treas. Reg. § 1.167(a)-1 (1964):

(a) Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis. . . . The allowance shall not reflect amounts representing a mere reduction in market value. . . .

(b) . . . the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business. . . . This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. . . . The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination.

experience in business.[9] The taxpayer should also estimate the reasonable salvage value on the basis of past experience. The result is that both of these steps must be taken prospectively. If the taxpayer's estimates are reasonable, he has complied with the standards of the regulations, and should be entitled to the deduction so long as he holds the asset and no clear and convincing evidence for a redetermination exists.[10] What constitutes a miscalculation subject to redetermination? This can be answered in part by stating what is not a miscalculation. The regulations provide that gains resulting from changes in market value do not permit redetermination of salvage value.[11] The court felt in the instant case that the government was obliged to disprove the plaintiff's claim that his gain was due to a change in market price. The court said:

> However, when the taxpayer sells his asset at an earlier time, for some reason which could not have been foreseen, that act in and of itself is not enough to cause a change in the estimates . . . . The mere fact of sale at an amount higher than the adjusted basis does not, ipso facto, *prove* that the estimates were *incorrect,* so there is no reason to readjust them and disallow depreciation in year of sale.[12]

The court suggests that evidence of resale price is not enough, but that the government actually bear a burden of disproof. Stated another way, the passage above quoted suggests that there is emerging a rebuttable presumption that all such gains are due to changes in market value, and under the regulations do not support a redetermination.

The Tax Court has taken a similar view. In *Macabe,*[13] the taxpayer corporation unexpectedly disposed of a building substantially before the end of its estimated useful life. The Service disallowed depreciation in the year of sale since sale proceeds exceeded depreciated basis. The Tax Court reversed the Service, expressly rejecting the Second Circuit cases.[14] Actual sale price, according to the Tax Court, bears little if any relevance to the property's salvage value. Concepts of depreciation through exhaustion, and appreciation or depreciation due to market conditions cannot be equated. Salvage value, held the *Macabe* court, is totally different from the amount received upon the sale of an asset, except when the asset is sold at or near the end of its useful life. The court further stated that salvage proceeds and actual duration of use of depreciable property may be used to correct a depreciable base only when a miscalculation has been made. The

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[9] Portland Gen. Elec. Co. v. United States, 223 F. Supp. 111 (D. Ore. 1963); Treas. Reg. § 1.167 (a)-1(b) (1964).

[10] See Treas. Reg. § 1.167(a)-1(b) (1964).

[11] Treas. Reg. § 1.167(a)-1(a) (1964).

[12] Occidental Loan Co. v. United States, 235 F. Supp. 519, 523 (S.D. Cal. 1964). (Emphasis added.)

[13] Macabe Co., *supra* note 2.

[14] *Supra* note 3.

Service has made no determination that the original estimate of useful life or salvage value was inaccurate according to the court.

The court in the instant case also felt that the Government had failed to provide a basis for disallowance of depreciation in the year of sale. The court felt that the Service had been untrue to its own dictates, both in the regulations [15] and in Revenue Ruling 62-92.[16] Although both require clear and convincing evidence to redetermine the depreciation basis, the revenue ruling expressly follows the *Cohn* rule disallowing year-end depreciation if the sale price exceeds the basis at the beginning of the tax year.

The Service's policy as expressed in Revenue Ruling 53-90 [17] and quoted with approval in Revenue Ruling 62-92 [18] is generally not to disturb depreciation deductions [except in the face of a clear and convincing basis to effectuate] its principal purpose of reducing controversies with respect to depreciation. The court intimated that the Service was not hewing faithfully to its announced policy by redetermining depreciation without clear and convincing evidence. In the instant case, the increased sale price has not been shown to result from causes beyond market value and the regulations specifically deny the Service the right to redetermine on that basis.[19]

The *Cohn* rule has been criticised as a mistaken interpretation of an incorrect case.[20] The writers seem to assume that proving *Cohn* wrong brings down Revenue Ruling 62-92. Not so. The Commissioner is bound only by Supreme Court decisions, and these he may distinguish. The point remains that simple fairness and the large sums at stake dictate some form of uniformity.

Uniformity is likely to come, if at all, from three sources: Commissioner acquiescence, congressional action, or a Supreme Court decision. It is doubtful that the Commissioner will acquiesce since he has ample court authority supporting his view, *i.e., Motorlease* [21] and *Fribourg Nav. Co.*[22] Nor is Congress likely to act since sections 1245 and 1250 of the Internal Revenue Code were drawn with all the evidence of the problem at hand, yet both sections according to the committee reports [23] expressly do not

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[15] Treas. Reg. § 1.167(a)-1(b) (1964), which requires a clear and convincing basis for any such redetermination.

[16] Rev. Rul. 62-92, 1962-1 Cum. Bull. 29:

> The depreciation deduction for the taxable year of disposition of an asset used in the trade or business or in the production of income, otherwise properly allowable under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from sale or exchange.

[17] Rev. Rul. 53-90, 1953-1 Cum. Bull. 43.

[18] Rev. Rul. 62-92, 1962-1 Cum. Bull. 29.

[19] Treas. Reg. § 1.167(a)-1(a) (1964).

[20] See Horvitz, "Although CA-2 upholds IRS on year-of-sale depreciation, Cohn rule may help taxpayers," 21 J. Taxation 203 (1964); Merritt, "Government briefs in Cohn refute IRS disallowance of year-of-sale depreciation," 20 J. Taxation 156 (1964).

[21] *Supra* note 3.

[22] *Ibid.*

[23] S. Rep. No. 830, 88th Cong., 2d Sess. 133 (1964).

alter the depreciation disallowance ground rules. The answer, it seems, will have to come from the Supreme Court.

The case today is probably a moot question on the basis of the recent recapture sections of the Code. Section 1245 provides in part that post-1961 depreciation allowed shall be included as ordinary income, to the extent that proceeds from the sale or exchange of the asset exceed the adjusted basis of the asset, if sold in 1963 or later. The section does operate uniformly, and should serve to reduce controversies, however it does not effect depreciation determinations before its effective date.

Thus the context of such controversies will in the future involve pre-1962 deductions taken for depreciation of 1245 property or gain to the extent it exceeds post-1961 depreciation. It is to be hoped that the Supreme Court will place the burden upon the government to demonstrate the propriety of "back-door" recapture. Under the present policy of the Service, as exemplified in Revenue Ruling 62-92 and the argument in the instant case, some taxpayers are disallowed eleven months depreciation, others a few days in January. This is far from fair treatment. The better rule would be to indulge in a presumption that gains on such sales represent accretions in market value, and therefore to be disturbed only upon proof of a miscalculation in the first instance or by a showing of clear and convincing evidence. Such hindsight evidence of mere market value should be presumed insufficient.